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UNITED STATES
INTERNATIONAL TAXATION

2018 SUPPLEMENT TO THE 3RD EDITION

P.L. 115-97 (Tax Cuts and Jobs Act)

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Preface

Public Law 115-97 -- generally referred to as the Tax Cuts and Jobs Act ("TCJA") -- was signed into law on December 22, 2017. It made important changes to United States international taxation, especially as it relates to the taxation of foreign earnings by domestic corporations and their foreign subsidiaries. These changes occurred in three major areas:

First, the TCJA reduced the highest marginal United States corporate tax rate from 35 percent to a flat 21 percent. While this rate reduction applies to both domestic and foreign source income, the lowered rate is now much closer to the average corporate tax rate imposed by most industrialized countries. The rate reduction was designed to encourage investment in the United States, by making the United States tax rate more competitive with those in other countries where businesses might be operating or considering an investment.

Second, the TCJA exempted from United States taxation a large portion of foreign business profits earned by foreign corporate subsidiaries of United States corporations. It did so by permitting a 100 percent dividends-received deduction for dividends paid by these companies to their corporate owners. This change was designed, at least in part, to eliminate the additional United States tax on repatriated foreign earnings that was discouraging domestic corporations from investing those funds back into United States operations.

Third, Congress recognized that exempting foreign business profits from United States taxation could actually encourage outsourcing of business activities and jobs to other countries, especially countries with low (or nonexistent) tax rates. The TCJA contains certain provisions designed to counteract this effect. The most significant new provision is the tax on "global intangible low-taxed income," which is designed to ensure that United States taxpayers pay at least approximately a ten percent tax each year on their foreign source income -- either to foreign countries or, if not to them, to the United States. The TCJA also generally left in place, and in some cases even strengthened, existing safeguards designed to prevent United States taxpayers from avoiding tax on income earned through foreign subsidiaries.

This Supplement is intended to provide a brief introduction to the most significant changes caused by the TCJA related to United States international taxation. It generally does not discuss transition rules, although it does have a brief discussion of the transition tax on un-repatriated foreign source earnings held by foreign subsidiaries at the end of 2017. Furthermore, the Supplement does not modify the problems to reflect tax rate changes or elimination of the personal exemption following the TCJA. The material in this Supplement is based on current law as of July 10, 2018. Changes to the law after that date are not reflected herein.

Later editions of the Casebook will discuss the international tax changes made by the TJCA in more detail, and update the problems, text and reference materials.

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Table of Contents

		Page
Unit 1	**Residency Classification Rules**	**1**
	A. Code and Regulation Provisions	1
	B. Problems for Class Discussion	1
Unit 2	**Source Rules**	**2**
	A. Code and Regulation Provisions	2
	B. Problems for Class Discussion	2
	2.14 Mixed-Source Income	2
Unit 3.5	**The New § 245A Dividends-Received Deduction**	**4**
	A. Code and Regulation Provisions	4
	B. Problems for Class Discussion	4
	C. Overview	5
	3.5.01 100 Percent Deduction for Foreign Source Dividends	5
	3.5.02 Limitations	6
	3.5.03 Hybrid Dividends	7
	3.5.04 Coordination with Foreign Tax Credits	7
	3.5.05 Gain and Loss on the Sale of Specified Ten-Percent Owned Foreign Corporation Stock	8
	3.5.06 Transition Tax on Previously-Deferred Foreign Source Income	8
Unit 4	**Foreign Tax Credit: Overview**	**10**
	A. Code and Regulation Provisions	10
	B. Problems for Class Discussion	10
	C. Overview	10
	4.00 Taxpayers Eligible to Claim a Foreign Tax Credit	10
Unit 5	**Foreign Tax Credit: The "Deemed Paid" Credit**	**12**
Unit 6	**Foreign Tax Credit: The § 904 Limitation**	**13**
	A. Code and Regulation Provisions	13
	B. Problems for Class Discussion	13
	C. Overview	13
	6.02 The Basket System	14
	6.03A Foreign Branch Income	14

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			Page
	6.03B	Global Intangible Low-Taxed Income	15
	6.04	General Category Income	15
Unit 7	**Treatment of Foreign-Owned United States Investment Income**		**17**
Unit 8	**Treatment of Foreign-Owned United States Business Income**		**18**
Unit 9	**Taxation of Branch Profits and Investment in United States Real Property**		**19**
	A.	Code and Regulation Provisions	19
	B.	Problems for Class Discussion	19
	9.17	Base Erosion and Anti-Abuse Tax	19
Unit 13	**Introduction to Controlled Foreign Corporations**		**20**
	A.	Code and Regulation Provisions	20
	B.	Problems for Class Discussion	20
	C.	Overview	20
	13.02	United States Shareholder Defined	20
	13.03	Direct Ownership	21
	13.04	Indirect and Constructive Ownership	21
	13.04A	Duration of CFC Status	21
	13.05	Limitations of the Subpart F Regime	22
Unit 14	**Controlled Foreign Corporations - Subpart F Income**		**23**
	A.	Code and Regulation Provisions	23
	B.	Problems for Class Discussion	23
	C.	Overview	24
	14.01	Subpart F Income	25
	14.02	Foreign Personal Holding Company Income	25
	14.06A	Deemed Paid Credits	25
	14.06B	GILTI Overview	26
	14.06C	GILTI Calculation	27
	14.06D	GILTI Foreign Tax Credits	27
	14.07	Pro Rata Share	28
	14.08	Basis Adjustments	28
	14.09	Exclusions from Gross Income -- Previously Taxed Earnings and Profits	29
	14.10	Sale of CFC Stock	29

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Page

14.11 Foreign-Derived Intangible Income 29

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Unit 1

RESIDENCY CLASSIFICATION RULES

A. CODE AND REGULATION PROVISIONS

No changes.

B. PROBLEMS FOR CLASS DISCUSSION

No changes.

While most of the tax law discussed in Unit 1 was not directly affected by the TCJA, the choices to be made under the entity classification rules are not as clear as they previously were, given tax rate and other related changes. Previously, in cases of eligible (non-per-se) entities, taxpayers could choose between treatment as a partnership or disregarded entity on the one hand and a corporation (i.e., an association) on the other. This was typically a choice between a top rate of 35 percent on corporate earnings and 20 percent on subsequent dividends or capital gain realized by shareholders versus a top rate of 39.6 percent (or 20 percent for capital gains) if operations were conducted as a partnership or a disregarded entity owned by individuals (or a 35 percent rate on such pass-through income owned by corporations). Under the new law, the choice between operating a business in corporate or non-corporate form changes dramatically given the new 21 percent corporate rate versus the maximum 37 percent individual rate, with new section 199A further reducing the effective rate of tax on certain qualified business income earned by individuals.

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Unit 2

SOURCE RULES

A. CODE AND REGULATION PROVISIONS

No changes.

B. PROBLEMS FOR CLASS DISCUSSION

No changes.

2.14 Mixed-Source Income

Section 2.14 should be replaced with the following material.

Historically, § 863(b) and related Treasury Regulations split the sourcing of a taxpayer's production and sales income into its component parts when the inventory was manufactured partly or wholly within (or without) the United States and sold outside (or within) the United States. Regulation § 1.863-3(b) specifies three methods for allocating income from what the Regulations refer to as "§ 863 sales": the "50/50" method, the independent factory price ("IFP") method, and the taxpayer's own books and records method. In general, the 50/50 method was preferred by United States taxpayers because it often maximized foreign source income and therefore foreign tax credits, as discussed in Unit 6. However, a taxpayer was able to elect out of this method by using either the IFP method or the taxpayer's own books and records method.

Under the prior rules, in the absence of an election otherwise, the 50/50 method applied to inventory property sourced under § 863(b). Under Regulation § 1.863-3(b)(1), the 50/50 method divided manufacturing gross income equally between production activity and sales activity. The production half was sourced under Regulation § 1.863-3(c)(1); the sales half under Regulation § 1.863-3(c)(2). Subject to a number of exceptions, paragraph (c)(1) sourced production activity income according to where the taxpayer's production assets were located, while income from sales activity was sourced according to the title passage rule of Regulation § 1.861-7(c).

For tax years beginning after December 31, 2017, the source of income arising from such § 863 sales is based solely on the taxpayer's production activities under § 863(b)(2) as amended by the TCJA. In the outbound context, this change in law thus dismantled an export subsidy that often followed from the favorable sourcing rules included in the Regulations.

Following the enactment of the TCJA, the sourcing rule for production-and-sale income contained in § 863(b) was modified such that all of the income will be treated as United States source income if the inventory is manufactured solely within the United States, even if value additive activities occur outside the United States and attract foreign taxes. Conversely, all of the income will be treated as foreign source income if the inventory is manufactured solely outside the United States.

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When the taxpayer's production assets are located both within and without the United States, pending the issuance of updated guidance, the pre-existing Regulations provide a reasonable approach for prorating the income between foreign and United States sources. Under Regulation § 1.863-3(c)(1)(ii), the income would be allocated to foreign sources based on a fraction, the numerator of which is the average adjusted basis of the taxpayer's foreign production assets and the denominator of which is the average adjusted basis of the taxpayer's worldwide production assets. The remaining income would be treated as United States source.

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Unit 3.5

THE NEW § 245A DIVIDENDS-RECEIVED DEDUCTION

A. CODE AND REGULATION PROVISIONS

Code §§ 61(a)(7); 164(a)(3), (b)(3); 245A; 246(c); 901(a), (b); 904(b)(5); 951(b); 957(a), (c); 961(d); 1248(a), (j).

B. PROBLEMS FOR CLASS DISCUSSION

3.5-1. On December 30, 2017, Domco Inc., a Delaware corporation, forms Venco S.A. as a wholly-owned Venezuelan corporation. In 2018, Venco earns $100,000 selling handbags to customers in Caracas, and pays $34,000 in Venezuelan income taxes. On December 31, 2018, Venco pays a $50,000 dividend to Domco, which is subject to Venezuelan withholding tax of $7,500. Assume none of Venco's earnings are subject to subpart F of the Code.

(a) What is Domco's United States tax liability with respect to the dividend received from Venco?

(b) May Domco claim a foreign tax credit against its United States tax liability for the $34,000 Venezuelan tax payment? What about the $7,500 Venezuelan withholding tax?

3.5-2. Assume the same facts as in 3.5-1, except that the Venco stock is owned by Domco LLC, a Delaware limited liability company wholly owned by Domco.

(a) How would your answers to 3.5-1 change?

(b) Assume that Domco LLC was wholly owned not by Domco, but by Dominic Costas, a United States citizen. How would your answers to 3.5-1 change?

3.5-3. Assume the same facts as in 3.5-1, except that Domco forms Venco on February 1, 2018, and sells all the Venco stock for no gain or loss on January 15, 2019. How would your answers to 3.5-1 change?

3.5-4. EmpireCo Inc., a New York corporation, owns all the stock of IrishCo LTD, an Irish corporation. EmpireCo's basis in its IrishCo stock is $600,000. During 2018 and 2019, IrishCo earns a total of $800,000 providing financial services to companies with operations in Ireland, and pays $120,000 in Irish income taxes. On January 1, 2020, EmpireCo sells the IrishCo stock to an unrelated company for $2,000,000. What is EmpireCo's United States tax liability with respect to its sale of the IrishCo stock? Assume none of IrishCo's earnings are subject to subpart F of the Code.

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3.5-5. Assume the same facts as in 3.5-4, except that IrishCo pays a $650,000 dividend to EmpireCo, and immediately thereafter EmpireCo sells the IrishCo stock for $500,000. What are the United States tax consequences to EmpireCo from the dividend and sale of the IrishCo stock?

C. OVERVIEW

Students should begin by reading the "Overview" section of Unit 4, pages 61-63 of the current edition of the Casebook.

In 2017, United States tax policy shifted significantly toward the territorial end of the spectrum. As discussed in this Unit, the enactment of § 245A allows domestic corporations to claim a 100 percent dividends-received deduction on certain dividends received from foreign corporate subsidiaries -- thereby effectively exempting the dividend from United States taxation by allowing a fully-offsetting deduction against the dividend income.

Notwithstanding this participation DRD, the United States has not abandoned entirely the foreign tax credit system. For example, as discussed in later Units, the credit system remains in place for foreign branch income earned by United States persons. In addition, the Code now contains an expanded set of safeguard provisions which require United States shareholders of foreign corporations that earn certain types of income to report such income currently. Relief from double taxation on income that is deemed included on a current basis in a United States person's taxable income is provided through the foreign tax credit system (rather than through the territorial system). International tax practitioners must therefore be familiar with the mechanics for both the Code's territorial system and its credit system.

3.5.01 100 Percent Deduction for Foreign Source Dividends

Code § 245A(a) permits a domestic corporation that qualifies as a United States shareholder of a specified ten-percent owned foreign corporation to deduct 100 percent of the foreign-source portion of any dividend received from such foreign corporation -- the so-called "participation DRD."[1] The effect of the provision, as noted in the TCJA legislative history, is to "allow[] an exemption for certain foreign income by means of a 100-percent deduction for the foreign-source portion of" certain dividends.[2] The provision is effective for distributions made after December 31, 2017.

[1] Code §§ 241 through 245 allow domestic corporations a 50 to 100 percent dividends-received deduction in other contexts, both domestic and foreign.

[2] Jt. Explanatory Statement of the Committee of Conference, Tax Cuts and Jobs Act (P.L. 115-97), p. 470 (2017) ("Jt. Comm. Rept").

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3.5.02 Limitations

The participation DRD is subject to several limitations. As a threshold matter, only domestic corporations can claim the deduction; individuals and trusts are not entitled to the deduction.

Only domestic corporations that qualify as "United States shareholders" can claim the deduction.[3] A United States person will be classified as a United States shareholder if such person owns at least ten percent of the foreign corporation's stock, measured by either voting power or value. Section 951. (Prior to 2018, and as discussed in Unit 13, the definition of United States shareholder required ownership of at least ten percent measured solely by voting power. The TCJA expanded the definition of United States shareholder to include ownership of at least ten percent of the foreign corporation's stock, measured by vote *or* value.) Robust indirect and constructive ownership rules -- also expanded by the TCJA -- apply for determining if a person qualifies as a United States shareholder. Section 958.

The dividend must be from a "specified ten-percent owned" foreign corporation. A specified ten-percent owned foreign corporation is simply a foreign corporation which has at least one United States shareholder (as defined above) that is a domestic corporation.

And the deduction is limited to only the "foreign-source portion" of the dividend received. The portion of a dividend considered foreign source is calculated by multiplying the dividend received by a fraction, the numerator of which is the foreign corporation's undistributed foreign earnings and profits, and the denominator of which is such foreign corporation's total undistributed earnings and profits. Earnings and profits will be considered foreign source if, generally speaking, those earnings are not attributable to a United States trade or business. Section 245A(c)(3).

The § 245A deduction cannot be claimed unless the recipient domestic corporation has held the foreign corporation's stock for more than 365 days over the 731-day period that begins on the date that is 365 days before the date on which the dividend is paid (or, where the stock is traded, the date on which the stock becomes ex-dividend with respect to such dividend). Additionally, at all times during the relevant 366-day period (i) the foreign corporation paying the dividend must be a specified ten-percent owned foreign corporation (discussed above), and (ii) the domestic corporation must be a United States shareholder with respect to such foreign corporation. Under § 246(c)(4), the holding period is suspended for any period during which the taxpayer claiming the participation DRD has substantially diminished its risk of loss in the stock through various hedging transactions, such as options to sell (or short sales of) the foreign corporation's stock, selling options to purchase the foreign corporation's stock, or holding offsetting positions with respect to substantially similar or related property.

[3] The legislative history to § 245A makes clear that dividends received by a domestic corporation through a partnership may be eligible for the participation DRD if the domestic corporation owns -- albeit indirectly -- at least ten percent of the foreign corporation's stock. Jt. Comm. Rept. at 470.

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3.5.03 Hybrid Dividends

Under § 245A(e), the § 245A deduction is disallowed with respect to hybrid dividends received by a United States shareholder from one of its controlled foreign corporations. A hybrid dividend is one in which the controlled foreign corporation making the payment receives a foreign income tax deduction (or other foreign tax benefit) with respect the payment, and the recipient United States shareholder would otherwise be eligible for the § 245A dividends-received deduction. Additionally, the recipient domestic corporate United States shareholder can claim neither a foreign tax credit nor a deduction for any foreign income taxes (e.g., withholding taxes) actually imposed on any such hybrid dividend.[4]

Payments of hybrid dividends on such instruments might -- absent legislation to the contrary -- be considered deductible interest payments by the payor foreign corporation, but as dividends received by the domestic payee corporation eligible for a 100 percent participation DRD. Examples of potential hybrid dividends include (i) a foreign country granting a foreign corporation a dividends-paid deduction, similar to those available to mutual funds in the United States; and (ii) an instrument issued by a foreign corporation that is classified as equity for United States tax purposes, but as debt for relevant foreign tax purposes.[5]

3.5.04 Coordination with Foreign Tax Credits

In certain circumstances a domestic corporation can claim a foreign tax credit to offset United States income tax on such corporation's foreign source income. Potentially creditable foreign taxes include, for example, withholding taxes on dividends paid by a foreign company to its United States owners.[6]

But where the participation DRD has eliminated United States tax on the dividend, it makes no sense to allow the taxpayer to claim a foreign tax credit on what is effectively tax-exempt income. The credit might then be used to offset tax on other, unrelated foreign source income earned by the taxpayer and not eligible for the participation DRD. Code § 245A(d) eliminates this potential double benefit by disallowing a foreign tax credit (or domestic deduction) for any taxes paid or accrued with respect to any dividend eligible for the participation DRD.

[4] Code §245A(e)(2) contains additional rules for taxing hybrid dividends paid by one foreign corporation to another foreign corporation, where each is a controlled foreign corporation with respect to which a domestic corporation is a United States shareholder.

[5] Historical examples of such hybrid instruments include certain versions of "convertible preferred equity certificates" and "mandatorily redeemable preferred shares." The classification of these instruments can change based on changes in relevant United States and foreign tax law, and variations in the terms of the instruments. As a result, no given instrument can confidently be declared a hybrid instrument absent additional inquiry.

[6] Creditable taxes also can include foreign income taxes paid by a controlled foreign corporation, where such corporation's earnings are included in the income of United States shareholders under subpart F of the Code.

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3.5.05 Gain and Loss on the Sale of Specified Ten-Percent Owned Foreign Corporation Stock

The participation DRD applies only to certain *dividends* received by domestic corporations from their ten-percent owned foreign corporations. It does not apply to gain recognized on the sale of the foreign corporation's stock -- gain that could well represent, at least in part, earnings and profits which, if distributed, would be eligible for the participation DRD.

To eliminate this discontinuity, § 1248(a) generally recharacterizes gain on a ten-percent shareholder's sale of a controlled foreign corporation's stock as a dividend from such foreign corporation, to the extent of the foreign corporation's earnings and profits allocable to the stock sold. If the selling shareholder is a domestic corporation, the gain-recharacterized-as-a-dividend is then potentially eligible for the participation DRD under § 1248(j), thereby avoiding the discontinuity described above.[7]

A related discontinuity can arise where a dividend subject to a 100 percent participation DRD is received, followed by a sale of the foreign corporation's stock at a loss. Under § 961(d), if a domestic corporation receives a dividend from a foreign corporation eligible for the participation DRD, then solely for purposes of determining loss on the sale of such foreign corporation's stock, the selling shareholder's tax basis in such stock is reduced (not below zero) by the amount of any previously-allowable § 245A deduction with respect to such stock. This is designed to prevent the combination of tax free income and offsetting taxable loss. Consistent with this purpose, § 961(d) applies only for purposes of determining loss, and basis is reduced only to the extent of § 245A-eligible dividends previously received by the selling shareholder.

3.5.06 Transition Tax on Previously-Deferred Foreign Source Income

At the end of 2015 there was an estimated $2.6 trillion of foreign-source income earned by foreign subsidiaries of United States taxpayers which had not been subject to United States tax.[8] These earnings were often described as "trapped" offshore because repatriation would cause the taxpayer to owe residual United States tax on the earnings, equal to the excess of the United States income tax on such earnings (pre-foreign tax credit) over the foreign tax levied on such earnings. Since much of the trapped earnings bore little if any foreign taxes, and the prevailing United States corporate tax rate was 35 percent, repatriation was an expensive proposition.

With the United States transitioning to a participation DRD, a significant issue arose: should the United States forego tax on this trapped income by permitting a participation DRD when these earnings were repatriated? Or should it keep the prior system in place with respect to these earnings, presumably keeping the earnings "trapped" offshore?

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[7] Code § 1248 was originally enacted in 1962, well before the 2017 addition of §245A, and addressed a similar discontinuity under prior law. This original application of §1248 will be addressed in the discussion of controlled foreign corporations in a later Unit.

[8] Jt. Comm. Tax., Letter to Chairman Kevin Brady and Hon. Richard Neal, U.S. House of Representatives, Aug. 31, 2016.

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Congress chose a middle approach instead, amending § 965 into what is now a long and technically challenging provision. In general, § 965 requires United States shareholders owning at least ten percent of certain foreign corporation's stock by vote to include in income such corporation's post-1986 deferred foreign earnings and profits (as calculated on November 2, 2017 or December 31, 2017, whichever date produces the greater amount of deferred earnings) (the "§ 965 amount"). The income inclusion occurs on the last day of the foreign corporation's tax year that began before January 1, 2018 (i.e., on December 31, 2017 for calendar year taxpayers). Aggregation of related foreign subsidiaries' surplus and deficit in earnings and profits is allowed.

The § 965 amount is subjected to a reduced level of United States tax. Generally, the portion of the § 965 amount attributable to the United States shareholders' aggregate foreign cash position is taxed at a 15.5 percent rate, and the remaining portion is taxed at an eight percent rate (the rate reductions being achieved through § 965(c) deductions partially offsetting the § 965 amount). Domestic corporate taxpayers reporting § 965 amounts can claim a deemed foreign tax credit for allocable taxes paid by the specified foreign corporation. However, to prevent United States shareholders from claiming foreign tax credits on income that is effectively exempt from United States taxation, the foreign taxes are reduced by that portion of the §965 amount that is sheltered by the § 965(c) deductions.

A taxpayer can elect to pay the tax on the § 965 amount over an 8-year period (with the payment schedule backloaded), without interest. Payments are accelerated upon certain triggering events. Section 965(h).

Since § 965 deals with pre-2018 foreign earnings, its focus is on the past. However, the potential tax on aggregate § 965 amounts is extremely large, and will cause tax professionals to devote equally significant time to its provisions. The impact of actual distributions of pre-2018 earnings on post-2017 years is also bound to give rise to additional, unanticipated complications over the next several years.

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Unit 4

FOREIGN TAX CREDIT: OVERVIEW

A. CODE AND REGULATION PROVISIONS

Also read Code § 245A(d).

B. PROBLEMS FOR CLASS DISCUSSION

No changes.

C. OVERVIEW

Students should review the Unit 3.5 Overview, including the "Overview" section of Unit 4, pages 61-63 of the current edition of the Casebook.

The participation DRD is one approach to reducing double taxation of foreign source income earned by United States taxpayers, but its scope is relatively narrow. Code § 245A applies only to dividends received by certain ten percent domestic corporate shareholders from specified ten-percent owned foreign corporations. What about cases that fall outside this Code section? In these situations, the United States has opted to reduce double taxation on a United States taxpayer's foreign source income not by exempting the income, but by granting the United States taxpayer a dollar-for-dollar credit for foreign taxes paid against the domestic taxes otherwise imposed on such income.

4.00 Taxpayers Eligible to Claim a Foreign Tax Credit

Add the following new subsection 4.00.

Under § 901(a) and (b)(1), any United States citizen, resident alien or domestic corporation is allowed a credit against United States income taxes for any foreign and possession "income, war profits, and excess profits taxes" paid by the taxpayer. The TCJA effectively reduced the scope of this allowance by disallowing a foreign tax credit (or domestic deduction) for any taxes paid or accrued with respect to any dividend eligible for the participation DRD. Section 245A(d).

The result of the § 245A(d) carveout is to leave the foreign tax credit system in place for all foreign source income received by all United States taxpayers *except* dividends eligible for the participation DRD. The foreign tax credit system thus continues to apply in many situations. For example, all non-corporate taxpayers will find relief from double taxation, if at all, through the foreign tax credit mechanism. Even domestic corporations will find themselves utilizing this mechanism with respect to any foreign source income received that is not otherwise eligible for the participation DRD. Situations most likely to give rise to significant foreign tax credits include foreign businesses operated by domestic taxpayers as branches (or in flow-through entities), where the foreign country levies a tax on those business earnings, and those earnings are also included in

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the domestic taxpayer's worldwide income for United States tax purposes. Foreign earned income not excluded from United States taxation under § 911 is another example where foreign tax credits might be claimed. Foreign country withholding taxes on dividends or other foreign source passive income earned by domestic taxpayers represent a third example where foreign tax credits might be claimed; however, neither a credit nor a deduction is permitted if the dividend gives rise to a participation DRD.

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Unit 5

FOREIGN TAX CREDIT: THE "DEEMED PAID" CREDIT

Unit 5 was rendered obsolete by the TCJA. See the discussion below.

Prior to the TCJA, § 902 permitted domestic corporations receiving a dividend from certain foreign subsidiaries to claim a foreign tax credit for the foreign income taxes paid by the subsidiary attributable to the after-tax earnings distributed as a dividend to the domestic corporation. While the foreign dividend was included in the domestic corporation's income, the foreign taxes paid by the foreign corporation attributable to the dividend were deemed paid by the domestic corporation, thereby effectively reducing the United States tax on the dividend to the extent of the related foreign tax credits. Unit 5 of the Casebook covers the workings of §902 under prior law.

The TCJA enacted the participation DRD, which effectively exempts from United States taxation the dividend received by a domestic corporation from its foreign subsidiary. As a corollary to this provision, the TCJA repealed § 902, thereby eliminating the ability of taxpayers eligible for the participation DRD to claim "indirect" or "deemed paid" foreign tax credits.

While § 902 has been repealed, remnants of this mechanism remain in place with respect to foreign earnings required to be included in current income under various safeguard provisions. This deemed paid foreign tax credit mechanism is now discussed more fully in Unit 14 (and the supplement thereto).

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Unit 6

FOREIGN TAX CREDIT: THE § 904 LIMITATION

A. CODE AND REGULATION PROVISIONS

Also read Code §§ 904(d)(3)(E); 951; 957(a); 960(d).

B. PROBLEMS FOR CLASS DISCUSSION

Add the following new problem:

6-4. Staplers Inc. is a Delaware corporation selling office supplies in the United States and abroad. It owns all the equity in (i) Staplers LLC, a Delaware LLC that operates in Great Britain and is classified as a disregarded entity for United States tax purposes; and (ii) Staplers B.V., a Dutch company that elected to be classified as a corporation for United States tax purposes. During Year 1, Staplers Inc. earns $3,000,000 from domestic sales; Staplers LLC earns $1,000,000 from sales in Great Britain (paying $150,000 in British income tax); and Staplers B.V. earns $500,000 from sales in the Netherlands (paying $200,000 in Dutch income tax). At the end of Year 1, Staplers B.V. pays Staplers Inc. a $100,000 dividend, subject to Dutch withholding tax of $10,000. Assuming a United States tax rate of 21 percent on Staplers Inc.'s income and none of Staplers B.V.'s earnings are subject to subpart F of the Code:

(a) What is Staplers Inc.'s United States tax liability for Year 1?

(b) How would your answer to (a) change if Staplers B.V. elected to be classified as a disregarded entity for United States tax purposes?

C. OVERVIEW

The final paragraph of the Unit 6 Overview should be replaced with the following material:

Code § 904(a) limits a taxpayer's foreign tax credit to the pre-credit United States tax on the foreign source portion of such taxpayer's worldwide income. But the overall limitation contained in § 904(a) is never applied directly. Instead, § 904(d) applies the limitation separately to a series of defined categories of income, often referred to as separate "baskets" of income. As discussed below, this prevents foreign taxes paid on income in one basket from being utilized to offset United States tax on not just domestic source income, but also on foreign source income in other baskets.

Modifying the overall limitation to apply separately to different baskets has been a feature of the Code for decades, although the type and number of baskets has varied significantly over time. For many years, the United States used a "per country" limitation on foreign tax credits, which prevented taxes paid to one foreign country from being used to offset taxes due to the United States on income earned in a different foreign country. (Remnants of this approach can be seen in

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Regulation § 1.904-1(a), which has never been amended to reflect repeal of the per-country limitations.) The United States now defines the baskets based on type of income, but the number of these baskets has also varied over time. Prior to the TCJA, there were only two baskets. The TCJA expanded the number of baskets to the current four baskets discussed below.

As the discussion proceeds, it should be remembered that § 904 does not create foreign tax credits, but is simply a *limitation* on foreign tax credits -- if the actual creditable foreign taxes paid are less than the § 904 limitation related to those credits, only the amount of foreign taxes actually paid can be claimed as a credit against United States tax liability.

6.02 The Basket System

The following material should be read as a supplement to the existing subsection 6.02.

The TCJA ushered in the latest iteration of § 904 baskets. It retained the passive category income and general category income baskets, but added two new baskets: a basket for "foreign branch income," and a basket for "global intangible low-taxed income" under § 951A (in each case, other than passive category income).[9] Section 904(d)(1).

6.03A Foreign Branch Income

Add the following new subsection 6.03A and subsection 6.03B.

The TCJA added a new basket, the foreign branch income category. Section 904(d)(1)(B). This category consists of business profits (other than income characterized as passive category income) earned by a United States person attributable to one or more qualified business units operating in one or more foreign countries. Regulations will specify how much profit should be attributed to a given qualified business unit. A qualified business unit is defined to be a separate and clearly-identified unit of a taxpayer's trade or business which maintains separate books and records. Section 989(a).

Foreign branch income will arise when the taxpayer operates its foreign business directly or, perhaps more likely, through an entity classified as a disregarded entity or partnership for United States tax purposes. For example, a United States person might own all the equity of a German entity which, under Regulation § 301.7701-3(b), is classified as a disregarded entity. Any business income generated by this German entity will be deemed earned directly by the United States person, and in all likelihood would be considered foreign branch income. The same would be true for a United States person who is a partner in a foreign partnership that generates foreign business income.

Dividends received by a United States person from a foreign corporation do not constitute foreign branch income, even if the foreign corporation is actively engaged in business and the

[9] In addition, § 904(d)(6) creates a separate basket for certain income items that are treated as United States source under the Code but reassigned as foreign source by treaty, thereby limiting the beneficial effects of the treaty provisions.

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dividends are paid out of after-foreign-tax business profits.[10] As noted above, such dividends will be classified as passive category income, except to the extent excluded from the § 904 computations because the dividend is eligible for the 100 percent participation DRD. Section 904(b)(5).

6.03B Global Intangible Low-Taxed Income

Code § 951A requires a United States shareholder of any controlled foreign corporation to include in gross income each taxable year such shareholder's allocable portion of the controlled foreign corporation's global intangible low-taxed income ("GILTI") for such taxable year. The purpose behind this provision is to ensure that the combined "excess" foreign business income earned by a taxpayer's controlled foreign corporate subsidiaries either bears a minimum foreign tax of 10.5 percent (about 13 percent after 2025), or is subject to current United States taxation, albeit at a reduced rate of 10.5 percent for corporations.

Significantly for § 904 purposes, § 960(d) permits domestic corporate United States shareholders to claim a deemed paid foreign tax credit with respect to a portion of the foreign taxes attributable to the GILTI inclusion. It is the foreign source income related to these foreign tax credits that falls into the separate § 904(d)(1)(A) GILTI basket. Non-corporate United States shareholders must also include the GILTI amount in their taxable income, but non-corporate taxpayers are generally not entitled to a deemed paid foreign tax credit. With no foreign tax credits to claim, the § 904 limit on those credits is irrelevant.

6.04 General Category Income

Current subsection 6.04 should be replaced with the following:

After the TCJA, any foreign source income not included in any of the three previous income categories falls into a separate, residual basket called the general category income basket. Section 904(d)(1)(D).

Income classified in the general basket includes, most importantly, amounts deemed included in the income of domestic corporate United States shareholders from their controlled foreign corporations (other than amounts described in one of the other § 904(d) income categories) pursuant to the safeguard provisions of subpart F. Code § 960(a) (similar to § 960(d)) permits these domestic corporate taxpayers to claim a deemed foreign tax credit with respect to this deemed income inclusion. Thus, similar to the GILTI basket, it is the foreign source income related to these deemed paid foreign tax credits that falls into the § 904(d)(1)(D) general category basket.

Removing foreign branch income from the general category reduces taxpayers' ability to cross credit, since non-passive but low-taxed subpart F income can no longer be blended with high-tax foreign branch income in the general category (or vice versa). Similarly, before the TCJA,

[10] Prior to the TCJA, dividends paid by a foreign corporation to a domestic corporate ten percent shareholder out of the subsidiary's active business income were not considered passive category income. Instead the dividends were considered general category income, and the recipient could claim a deemed paid foreign tax credit under then-§ 902 for foreign taxes paid by the foreign subsidiary attributable to the dividend.

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dividends received by ten percent domestic corporate shareholders from their foreign subsidiaries carried with them an indirect foreign tax credit; the dividend was then included in the general category for purposes of the § 904 limitation. The participation DRD removed these dividends (and related foreign tax credits) from the foreign tax credit system entirely. It is thus no longer possible for taxpayers to blend income from foreign subsidiaries operating in high-tax jurisdictions with non-passive subpart F income from foreign subsidiaries operating in low-tax jurisdictions.

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Unit 7

TREATMENT OF FOREIGN-OWNED UNITED STATES INVESTMENT INCOME

The TCJA has had a limited impact on the text and problems in Unit 7. However, the temporary elimination of the personal exemption may have a small impact on the answers to certain problems.

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Unit 8

TREATMENT OF FOREIGN-OWNED UNITED STATES BUSINESS INCOME

The TCJA has had a limited impact on the text and problems in Unit 8. However, the temporary elimination of the personal exemption may have a small impact on the answers to certain problems. Furthermore, the problems in this Unit may be more significantly impacted by tax rate changes than other materials in the Casebook.

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Unit 9

TAXATION OF BRANCH PROFITS AND INVESTMENT IN UNITED STATES REAL PROPERTY

A. CODE AND REGULATION PROVISIONS

Also read Code § 59A.

B. PROBLEMS FOR CLASS DISCUSSION

No changes.

9.17 Base Erosion and Anti-Abuse Tax

Add the following new subsection 9.17.

The TCJA enacted § 59A, the so-called base erosion and anti-abuse tax ("BEAT"). This provision is designed to limit the ability of domestic corporations (with at least $500 million of domestic gross receipts over a three-year period) to reduce their United States tax liability by making certain types of deductible payments to related foreign persons. A foreign person is related to the taxpayer if, among other fact patterns, the foreign person owns at least 25 percent of the taxpayer, by vote or value (after application of stock ownership attribution rules). Section 59A(g).

Specifically, § 59A imposes each year a tax equal to (i) ten percent (five percent for 2018; 12.5 percent after 2025) of the taxpayer's modified taxable income over (ii) its regular pre-credit tax liability (reduced by most credits including foreign tax credits). A taxpayer's modified taxable income is equal to its taxable income, calculated without regard to the tax benefit arising from certain "base erosion payments" and a percentage of its net operating loss deductions. Section 59A(a), (b). Base erosion payments generally include deductible payments to related foreign persons, including the depreciable or amortizable portion of property acquired from related foreign persons. Section 59A(c)(2) and (d). However, such payments do not include payments for certain back office and low margin services. Section 59A(d)(5). The BEAT only applies if the tax benefit arising from the taxpayer's base erosion payments during the year is at least three percent of the taxpayer's total deductions for the year. Section 59A(e)(1).

Modified rules apply to banks, securities dealers, insurance companies, and payments to certain surrogate foreign corporations as defined in § 7874(a)(2)(B). Base erosion payments do not include payments that are effectively connected income to the foreign recipient, or are subject to the 30 percent tax under §§ 871 and 881 (the BEAT still applies to the extent the §§ 871/881 and related §§ 1441/1442 withholding taxes are reduced by treaty).

Base erosion payments can include payments made to a related foreign corporation, even if those payments give rise to income to the foreign corporation that the payor domestic corporation must in turn include in its income under various safeguard provisions contained in subpart F.

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Unit 13

INTRODUCTION TO CONTROLLED FOREIGN CORPORATIONS

A. CODE AND REGULATION PROVISIONS

Also read Code § 951A(a).

B. PROBLEMS FOR CLASS DISCUSSION

No changes.

C. OVERVIEW

The following material should be read as a supplement to the existing Overview.

As discussed in Unit 3.5, the enactment of § 245A shifted the United States closer to a territorial corporate taxing system. Certain corporate shareholders are now eligible for a 100 percent dividends-received deduction when the foreign corporation's earnings are distributed or, through § 1248(j), when the stock of the foreign corporation is sold. With the enactment of § 245A, and the lowering of the corporate tax rate to 21 percent, domestic corporations are now better equipped to compete with their foreign counterparts.

This shift towards a territorial taxing system, however, also placed additional pressure on the effectiveness of the subpart F regime discussed in Units 13 and 14. Were it not for the subpart F safeguard, corporate shareholders could earn profits in low-tax or no-tax jurisdictions and then repatriate such profits tax-free. The TCJA employed a two-pronged response to this concern. First, as discussed in this Unit, the TCJA expanded the instances in which United States persons and foreign corporations are subject to the subpart F regime. Second, as discussed in Unit 14, the TCJA enacted a new provision, § 951A, which ensures that the income of a controlled foreign corporation (CFC) is subject to at least a 10.5 percent tax, either in its country of organization and/or the United States.

13.02 United States Shareholder Defined

The following material should be read as a supplement to the existing subsection 13.02.

The definition of a United States shareholder was previously limited to those United States persons who owned at least ten percent of the foreign corporation's voting stock. Passive investors holding only a nonvoting or less than a ten percent voting stake in the foreign corporation were excluded from the definition. The TCJA expanded the definition of a United States shareholder to include any United States person who owns at least ten percent of the voting power *or* value of the foreign corporation's stock.

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13.03 Direct Ownership

The following material should be read as a supplement to the existing subsection 13.03.

The Regulations disregard arrangements that artificially shift the voting power away from the United States shareholders; however, over time this substance-over-form inquiry proved ineffective, particularly in preventing foreign-parented multinational corporations from avoiding the subpart F regime through bona fide arrangements that shifted the voting power to related foreign persons. Together with the expansion of the constructive ownership rules discussed below, the TCJA restricted these tax planning techniques by expanding the definition of a United States shareholder to also include any United States person who owns at least ten percent of the value of the foreign corporation's stock.

13.04 Indirect and Constructive Ownership

The following material should be read as a supplement to the existing subsection 13.04.

Prior to the TCJA, foreign-parented multinationals engaged in so-called CFC "decontrolling" transactions, in which more than 50 percent of the vote and value of a foreign corporation was shifted from the group's United States subsidiary to a related foreign party. For example, prior to the TCJA, assume a publicly-traded Dutch corporation owned all the stock of a United States corporation, which in turn owned all the stock of an Irish corporation. The Irish corporation is a CFC, and the United States corporation its sole United States shareholder. However, the Dutch corporation could invest additional funds directly into the Irish corporation in exchange for 50 percent of the Irish corporation's stock. The United States corporation would then no longer own directly or indirectly *more than* 50 percent of the Irish corporation's stock, because former § 958(b)(4) blocked the attribution of the Dutch corporation's Irish stock to its United States subsidiary.

In response to these and similar techniques, the TCJA expanded the scope of the constructive attribution rules under § 958(b). Stock owned by a foreign person is now attributed to a domestic corporation if the foreign person owns at least 50 percent of the value of the domestic corporation. Similarly, stock owned by a foreign partner is now attributed to its domestic partnership, though in this case without regard to any minimum ownership requirement.

Expanding the constructive ownership rules in this manner has more than shut down these decontrolling transactions; it has also resulted in a proliferation of foreign corporations that previously fell outside the ambit of the subpart F regime now being classified as CFCs.

Add the following new subsection 13.04A.

13.04A Duration of CFC Status

A foreign corporation is treated as a CFC if its United States shareholders (as defined above) own more than 50 percent of the corporation's stock by vote or value at any time during the tax year. Section 951(a)(1) previously prevented this hair trigger from resulting in a subpart F inclusion at the shareholder level, so long as the foreign corporation avoided CFC status for an

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uninterrupted period of 30 days during the tax year. This provided taxpayers with the opportunity of avoiding subpart F inclusions by entering into decontrolling transactions within 30 days of a foreign corporation becoming a CFC or, for pre-existing CFCs, within the first 30 days of the foreign corporation's taxable year. For instance, in the above example, if the Dutch corporation's investment occurred within the first 30 days of the Irish corporation's taxable year, the United States corporation would not be taxed on any subpart F income earned by the Irish corporation during the year.

Tightening the subpart F regime yet again, the TCJA repealed this 30-day safe harbor provision. United States shareholders may now suffer a subpart F inclusion regardless of the time period during which the foreign corporation was a CFC. Any such subpart F inclusion, however, would be based on a daily proration of the time period during the year in which the foreign corporation was a CFC. See Reg. § 1.951-1(b)(1)(i).

13.05 Limitations of the Subpart F Regime

As a result of the TCJA, Figure 13-1, Step 3, should read: “Did any such United States person directly, indirectly, or constructively own at least ten percent of the stock of the foreign corporation, as measured by vote or value, on any day of the year?”

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Unit 14

CONTROLLED FOREIGN CORPORATIONS – SUBPART F INCOME

A. CODE AND REGULATION PROVISIONS

Also read Code §§ 78; 250; 951A; 904(c), (d); 960.

B. PROBLEMS FOR CLASS DISCUSSION

Substitute the following revised problems 14-1 and 14-2:

14-1. A, B, and C, each United States citizens and residents, own one-third of the stock of Z Corporation, a Bolivian corporation formed as a Sociedad Anonima.

(a) In Year 1, Z Corporation earns $100,000 of interest income and $200,000 of dividend income from unrelated persons. What are the United States income tax consequences under subpart F other than § 951A?

(b) In Year 2, Z Corporation again earns $100,000 of interest and $200,000 of dividend income. It also opens a travel business in Bolivia, which generates $7,000,000 of gross income. How much of Z Corporation's income must be included in United States income under subpart F other than § 951A? What if Z Corporation generates $90,000 of gross income from its travel business?

14-2. Abe, a United States citizen, and DomCo, a domestic corporation wholly-owned by Abe, form Chala Co., a corporation under Peruvian law, on January 1, Year 1, with a contribution of $5,000 each in return for 50 shares of common stock. Chala Co. purchases equipment in the United States from DomCo and sells the equipment to independent parties in Peru and other South American countries. In Year 1, Chala Co. made $50,000 of net income from sales in other South American countries and $100,000 of net income from sales in Peru. Chala Co. is classified as a corporation for United States tax purposes. No foreign income taxes are paid by Chala Co. on its income.

(a) What are the United States income tax consequences for Abe, DomCo, and Chala Co. in Year 1 under subpart F other than § 951A?

(b) What is the result in (a) if Chala Co. paid income tax to the other South American countries of $7,500 on its income from sales in those countries?

(c) What result in (a) if Chala Co. in Year 2 derives no income for the year but distributes to Abe and DomCo $25,000 each?

(d) How would your answer to (a) change if Damien, an unrelated United States citizen and resident, owned eight percent of the stock of Chala Co., and Abe and DomCo owned 46 percent each?

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(e) Suppose Chala Co., owned solely by Abe and DomCo, makes the same $150,000 of income for each of Years 1 through 5, as specified in part (a). On January 1, Year 6, Abe sells his 50 shares to Martin, an unrelated Peruvian citizen, for $400,000.

(1) What are the United States income tax consequences of the sale to Abe?

(2) What result if DomCo (instead of Abe) sold its shares?

(f) How would your answer to (e) change if Damien owned eight percent of the stock of Chala Co., Abe and DomCo owned 46 percent each, and Damien sells his shares?

Add the following new problem:

14.-3 On January 1, Year 1, Jonesy, a United States citizen, and USCo, an unrelated domestic corporation, formed FiletCo, a calendar year Japanese corporation that specializes in serving the finest Cajun crusted bone-in filets and exotic wines in all of Japan. Jonesy and USCo each contribute $50,000 in exchange for 50 shares of FiletCo's common stock. Using this seed capital, on January 1, Year 1, FiletCo purchases inventory of $60,000 and invests the remaining $40,000 in ovens and other tangible equipment used in its restaurant operations. The assets used in FiletCo's business depreciate $1,000 each quarter using a straight-line convention.

Notwithstanding the stiff competition, FiletCo's business immediately won over the critics. During Year 1, FiletCo earned a net profit of $150,000, which amounts were reinvested into FiletCo's business for additional capital expenditures during Year 2. To attract new business ventures, the Japanese taxing authorities provide an exemption from Japanese tax for any profits earned by a newly-formed business during Year 1.

(a) What are the United States income tax consequences for FiletCo, Jonesy, and USCo in Year 1?

(b) In addition to the facts set forth in (a) above, assume Jonesy and USCo formed another Japanese corporation, KobeCo, on January 1, Year 1. Although the shareholders contributed the same amounts, and KobeCo invested the same amounts in the same type of assets as FiletCo, this venture was a flop, producing a $75,000 loss for Year 1. How would your answer to (a) change?

(c) How would your answer to (a) change if FiletCo also earned $100,000 of interest income from unrelated persons?

(d) How would your answer to (a) change if FiletCo pays $30,000 of foreign taxes in Year 1 on its $150,000 of net profit?

C. OVERVIEW

The following material should be read as a supplement to the existing Overview.

As discussed in Unit 13, the TCJA expanded the threshold requirements for subjecting

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United States persons to the subpart F regime. The TCJA also significantly expanded the scope of the subpart F regime with the enactment of § 951A, which subjects United States shareholders to current tax on their pro rata share of a CFC's deemed offshore intangible income. While this income is referred to as "global intangible low-taxed income" or "GILTI," it has only an attenuated connection to intangible property located offshore. It is also not limited to low-taxed income, but rather includes all CFC income, as adjusted, which exceeds a deemed ordinary return on tangible business assets owned by the CFC.

14.01 Subpart F Income

The following material should be read as a supplement to the existing subsection 14.01.

The TCJA repealed foreign base company oil related income as a category of subpart F. The legislative history indicates that doing so was necessary to ensure the domestic oil and gas industry remains globally competitive.

14.02 Foreign Personal Holding Company Income

The following material should be read as a supplement to the existing subsection 14.02.

The look-through rule, which is set forth in § 954(c)(6) and discussed in FN1, was extended to CFC tax years beginning before January 1, 2020 by the Consolidated Appropriations Act of 2016, P.L. 114-113, § 144(a), Div. Q.

Add the following new subsections 14.06A through 14.06D.

14.06A Deemed Paid Credits

Corporate United States shareholders may claim a credit with respect to any foreign taxes that are attributable to their subpart F inclusions. Individual United States shareholders, however, are less fortunate. They are generally precluded from claiming deemed paid credits, but may do so by opting into the corporate taxing regime under § 962.

Former §§ 902 and 960 worked in tandem to prevent the double taxation of a CFC's earnings when those earnings were distributed or deemed distributed to its corporate United States shareholders. In either case, the corporate shareholder could have claimed an indirect foreign tax credit based on a cumulative pooling of the CFC's taxes and earnings and profits. For example, if a CFC earned $100 in each of two years, and paid foreign taxes of $20 and $30 in years one and two, respectively, the CFC's earnings and profits would be $150 ($200 - $20- $30) and its foreign taxes paid would be $50. Dividends paid by the CFC to its domestic corporate parent would be out of the $150 pool of earnings and profits, and each $10 dividend carried with it an indirect foreign tax credit of $3.33 ($50 x $10/$150). The mechanics of this pooling approach were set forth in the Regulations under § 902.

The enactment of the § 245A dividends-received deduction eliminated the need to track a CFC's taxes based on the former pooling approach of § 902. This is because a CFC's income earned in a prior year is now no longer subject to United States tax when received by a corporate

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United States shareholder. Rather, the CFC's income is either earned in the current year and included in the shareholder's gross income under subpart F or, when distributed, is eligible for the 100 percent dividends-received deduction. As a result, the TCJA repealed § 902 and modified the mechanics of the deemed paid credits attributable to subpart F inclusions. Such deemed paid credits are now limited to a CFC's *current year* taxes that are "properly attributable" to the corporate shareholder's subpart F inclusion. Section 960(a). As discussed below, different mechanics apply with respect to deemed paid credits attributable to a corporate shareholder's GILTI inclusion.

Subpart F is limited to a CFC's current year earnings and profits, which amount is net of the CFC's foreign taxes. Section 952(c). If a corporate United States shareholder claims an indirect foreign tax credit, it must include such deemed paid taxes in gross income as a deemed dividend. Were it not for this § 78 gross-up requirement, the shareholder would receive a double tax benefit -- as a reduction in the CFC's earnings and profits, and thus the shareholder's subpart F inclusion, and as a credit against the United States tax imposed on the subpart F inclusion. Grossing up the shareholder's income in the amount of the deemed paid taxes balances the scales by eliminating the deduction benefit. Although the § 78 gross-up amount is treated as a dividend, it is of course not eligible for a dividends-received deduction. Section 78.

14.06B GILTI Overview

The GILTI regime backstops the TCJA's adoption of a quasi-territorial taxing system for certain corporate shareholders. Its objective is to prevent aggressive shifting of profits offshore, which can be brought back to the United States tax-free via the 100 percent dividends-received deduction. See Unit 3.5. This is accomplished by requiring a minimum foreign tax on a CFC's earnings that exceed a defined threshold. If the CFC's foreign earnings are not subject to this minimum foreign tax, the GILTI inclusion will attract an incremental United States tax on those earnings.

Unlike subpart F income, however, a United States shareholder's GILTI inclusion is not dependent on the CFC earning a particular category of income. Nor is there an exception for income inclusion for earnings subject to a high foreign tax rate, as there is for subpart F income. Instead, GILTI is included in the United States shareholder's gross income, whether or not distributed, whenever the CFC's taxable income, as adjusted, exceeds a deemed ten percent return on certain tangible depreciable property. Section 951A. By carving out this deemed return, the provision provides an incentive for taxpayers to increase their exempt return by acquiring tangible depreciable property offshore, which is peculiar given the TCJA's purported purpose of encouraging multinationals to locate or relocate their property onshore.

For corporate United States shareholders, the United States tax cost imposed on the GILTI inclusion is reduced by crediting 80 percent of the associated foreign taxes, if any, and claiming a 50 percent deduction against the GILTI inclusion and the full § 78 gross-up amount. Sections 960(d); 250(a)(1)(B). After taking these remedial measures into account, the United States tax imposed on a shareholder's GILTI inclusion is supposed to fall within a range of 10.5 percent (for CFCs not subject to foreign tax) and zero (for CFCs subject to a foreign tax rate of at least 13.125 percent). However, the allocation of interest and other expenses against a shareholder's GILTI inclusion can result in an incremental United States tax cost when the foreign tax rate exceeds

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13.125 percent.

While § 951A was ostensibly enacted to protect the corporate tax base, individual United States shareholders are also subject to its requirements. In fact, individual United States shareholders are treated less favorably than corporate United States shareholders. This is because individual shareholders cannot claim the 50 percent deduction under § 250 and, unless an election is made under § 962 to treat the individual as a corporate shareholder, individual shareholders are prohibited from claiming indirect foreign tax credits. To illustrate, assume a United States shareholder owns a CFC that is located in a no-tax jurisdiction such as the Cayman Islands. A GILTI inclusion of $100 will result in a United States tax of $37 if the shareholder is an individual and subject to the highest tax bracket. However, if the shareholder is a corporation, after taking into account the 50 percent deduction under § 250, only $50 of the inclusion will be subject to the 21 percent corporate tax rate, resulting in a United States tax of $10.50. Of course, such after-tax earnings will be taxed again when distributed to the corporation's individual shareholders.

14.06C GILTI Calculation

GILTI is effectively a full inclusion anti-deferral regime. Each year, each CFC calculates its "tested income" or "tested loss." Such tested income and tested loss amounts are aggregated and netted at the United States shareholder level based on the shareholder's direct and indirect ownership interest in each CFC on the last day of the tax year. Section 951A(c). The net positive amount, referred to as "net tested income," is then reduced by a deemed ten percent return on the average adjusted bases of certain tangible depreciable property used in the production of each CFC's tested income. A United States shareholder's GILTI inclusion is the amount by which its net tested income exceeds its deemed ten percent return. Section 951A(b).

The positive and negative components of net tested income, i.e., tested income and tested loss, are calculated at the CFC level. Tested income or tested loss is defined as the CFC's taxable income or loss calculated without regard to five amounts: The CFC's (i) United States source effectively connected income; (ii) subpart F income; (iii) income that would have been subpart F but for the high-tax income exception (discussed in 14.06); (iv) related party dividends; and (v) foreign oil and gas extraction income. Deductions (including taxes) allocable to these carve-out amounts are also carved out of the tested income or tested loss calculation. Section 951A(c)(2)(A).

A shareholder calculates its deemed ten percent return by including only those assets used in the production of the CFC's tested income. If a CFC has a tested loss, none of its assets are taken into account in this calculation. The United States shareholder's deemed ten percent return is also reduced by any net interest deductions attributable to the shareholder's net tested income. Section 951A(b)(2). This adjustment has the effect of neutralizing the benefit of debt-financed acquisitions of tangible depreciable property. To the extent such interest deductions reduce the shareholder's net tested income, the shareholder's deemed ten percent return, which creates a floor on the shareholder's GILTI inclusion, will be reduced by an equal amount.

14.06D GILTI Foreign Tax Credits

As with other subpart F inclusions, corporate United States shareholders may claim indirect foreign tax credits on their GILTI inclusion. Section 960(d). However, unlike other subpart F

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inclusions, only 80 percent of such taxes are creditable while the associated § 78 gross-up amount is not so limited. The calculation involves a pooling of the foreign taxes attributable to the domestic corporation's share of the CFCs' tested income (but not CFCs with tested losses) during the year, computed without regard to foreign taxes paid in prior (or subsequent) years. Such taxes are multiplied by a fraction, the numerator of which is the shareholder's GILTI inclusion and the denominator of which is the shareholder's aggregate tested income. Subject to the § 904 limitation discussed below, corporate United States shareholders may claim as a credit 80 percent of such taxes, provided 100 percent is included in the shareholder's gross income as a deemed dividend under § 78. Unlike foreign tax credits attributable to other § 904 baskets, any excess foreign tax credits are forever lost if not used in the year of inclusion. Section 904(c).

A shareholder's GILTI inclusion is treated as a separate basket for § 904 limitation purposes. Section 904(d)(1)(A). As a result of this limitation, any deemed paid taxes are only creditable up to 21 percent of the foreign taxable income that is included in the GILTI basket. Such foreign taxable income includes the 100 percent § 78 gross-up amount and the 50 percent deduction under § 250, which is claimed against both the GITI inclusion and the § 78 gross-up amount. If no other deductions are allocated against the shareholder's foreign taxable income, the GILTI inclusion will not attract an incremental United States tax cost whenever the foreign tax rate imposed on the included earnings is at least 13.125 percent.

To illustrate, assume a corporate United States shareholder has a GILTI inclusion of $100, and the CFC paid $50 of foreign taxes related to the GILTI income. The shareholder could claim $40 of deemed paid foreign taxes (80 percent of the foreign taxes actually paid, pursuant to § 960(d)(1)), subject to an associated § 78 gross-up of $50. The shareholder will recognize $150 of gross income ($100 + $50) and claim a $75 deduction under § 250 ($150 x 50%), resulting in GILTI foreign taxable income of $75 and a United States tax liability of $15.75 before foreign tax credits ($75 x 21%). The shareholder's allowable foreign tax credit is also $15.75, i.e., the lesser of its $40 of deemed paid taxes or its § 904 limitation of $15.75 ($75 of foreign source taxable income x 21%). Thus, given the high rate of foreign tax, the shareholder's GILTI inclusion will not attract an incremental United States tax cost.

This result is consistent with the legislative history. According to the Conference Report, "the minimum foreign tax rate, with respect to GILTI, at which no United States residual tax is owed by a domestic corporation is 13.125 percent." H.R. Rep. No. 115-466, at 498 (2017) (Conf. Rep.).

14.07 Pro Rata Share

The following material should be read as a supplement to the existing subsection 14.07.

A United States shareholder's pro rata share of a CFC's GILTI is determined in the same manner as the shareholder's pro rata share of subpart F income. Section 951A(e).

14.08 Basis Adjustments

The following material should be read as a supplement to the existing subsection 14.08.

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A United States shareholder's basis in the stock of a CFC is adjusted under § 961 to reflect the shareholder's GILTI inclusion in the same manner as a subpart F inclusion. Section 951A(f)(1)(A).

14.09 Exclusions from Gross Income -- Previously Taxed Earnings and Profits

The following material should be read as a supplement to the existing subsection 14.09.

A United States shareholder's GILTI inclusion is treated in the same manner as a subpart F inclusion for purposes of § 959. Section 951A(f)(1)(A).

14.10 Sale of CFC Stock

The following material should be read as a supplement to the existing subsection 14.10.

As discussed in 3.5.05, when stock of a CFC is sold by certain corporate United States shareholders, the recharacterized dividend component of the gain is eligible for the 100 percent dividends-received deduction. Section 1248(j).

Add the following new subsection 14.11.

14.11 Foreign-Derived Intangible Income

As discussed in 14.06B above, the GILTI regime imposes a current, albeit reduced, rate of tax on domestic corporations shifting their profits offshore to CFCs operating in low-tax jurisdictions. As a further inducement to operating onshore, § 250 creates a preferential corporate taxing regime for deemed onshore intangible property benefiting offshore markets. Similar to the GILTI inclusion, the targeted income is not subject to a reduced rate of tax, but is rather eligible for a special deduction that reduces the base upon which the corporate tax rate is imposed. Here, the deduction is 37.5 percent of the corporation's foreign-derived intangible income, thus producing an effective tax rate of 13.125 percent (21 percent x 62.5%) on such favored income—a rate designed to equate to the minimum foreign tax rate necessary to avoid tax under the GILTI regime.